CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

Subject:	Credit Enhancement - Credit Enhancement Policy	Item Number:	13
		Attachment(s):	4
Action:	X	Date of Meeting:	April 7, 1999
Information:		Presenters:	Mr. Rose

EXECUTIVE SUMMARY

One of the 1998-99 Investment Branch objectives was to "Complete an Investment Committee presentation evaluating the relative success of the Credit Enhancement Program as described to the investment committee in May 1994, as well as, to review and revise the Business Plan as necessary."

This agenda item includes the 1999-00 Business Plan (Attachment 1), Credit Enhancement Policies (Attachment 2), Credit Enhancement Glossary (Attachment 3), and Board Resolution (Attachment 4).

BACKGROUND

CalSTRS commenced its study to develop what is now called the Credit Enhancement Program in the fourth quarter of 1991. The original intent in studying the program was to explore whether CalSTRS could generate fee income for the fund by assisting construction finance efforts for California public schools. It was determined that restrictions in the California Education Code prohibited such transactions at the time. From the research, however, it was considered appropriate for CalSTRS to generate fee income as a credit enhancer for public and private activity bonds in the State of California.

The initial report to the Teachers' Retirement Board (Board) on the program was May 1992 followed by additional presentations in October 1992 and May 1993. Policies and Procedures for the credit enhancement program were completed and approved in February 1994.

A number of program updates and enhancements have been made since the Credit Enhancement program's inception. The most recent presentation was January 1998.

ACTUAL EXPERIENCE

The original five year objective was to have $1 billion in outstanding commitments (2% of outstanding assets at that time) generating $2 million per year in fee income. The first transaction of $25 million supporting the Port of Long Beach was executed in June 1994. As of July 1, 1999, the Credit Enhancement Program is expected to have approximately $800 million in outstanding commitments producing an expected $2 million of fee income per year.

Some business opportunities were lost over the past five years due to a lack of clear authority in the California Education Code which restricted CalSTRS from conducting business transactions which "inure to the benefit of a school district or other employing agency." This limitation was altered in the fall of 1998 with the passage of SB 2126 which permits CalSTRS to provide credit enhancement to employing agencies, subject to meeting fiduciary standards, and operating under the safe harbor established under Section 503 of the Internal Revenue Code.

BUSINESS PLAN

Attachment 1 is the 1999-00 Business Plan for the Credit Enhancement Program. This Business Plan highlights six different program components which are either ongoing, in development, or in exploratory stages.

Highlights	**Stage**
California Schools Credit Enhancement	Development
California Multifamily Housing Projects	Development
California Housing Projects	Ongoing
California Municipal Finance	Ongoing
California Industrial Development	Ongoing
National Credit Enhancement Program by Public Pension Consortium	Exploratory

The programs in the development stage for schools and housing will each merit a presentation to the Board as each one evolves.

Also included in the Business Plan is a request for Board approval to pursue an exploratory study of a national consortium of pension funds to provide credit enhancement for appropriate projects throughout the United States, including California projects.

The business objectives reflect the desire for the Credit Enhancement Program to be selective in writing new business with a prudent accumulation of risk. The proposed objectives are to:

1) selectively underwrite credit enhancement opportunities on a zero loss basis,

2) design and implement a California Schools Credit Enhancement Program,

3) design and implement a California Multifamily Housing Program,

4) and work with Standard & Poor's and Fitch rating services to raise the CalSTRS rating to AAA.

SIGNIFICANT POLICY MODIFICATIONS

Many of the modifications to the existing policy are made for the purpose of making the policy consistent in format and style with other investment policies. Other changes reflect legislation that went into effect January 1999 regarding employer related transactions. ***Policy is written that permits such transactions to take place up to 25% of a transaction for an "employer".***

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

CREDIT ENHANCEMENT PROGRAM

BUSINESS PLAN-FISCAL YEAR 1999/00

I. ROLE OF CREDIT ENHANCEMENT

The role of the CalSTRS Credit Enhancement Program (Program) is to provide fee income. The Program is an off-balance sheet component of the investment portfolio, enabling CalSTRS to use its substantial asset base and liquidity strength to generate fee income.

II. DESCRIPTION AND DEFINITION

Credit enhancement is a substitution of a highly rated financial institution's credit rating for that of a lower rated public or private entity. It is an agreement by a third party (CalSTRS) to pay the investor scheduled interest and/or principal payments in the event the primary obligor does not meet the terms and conditions of the bond indenture. This substitution (for a fee) allows the public or private entity access to the capital markets at a lower interest rate.

Credit enhancement transactions normally utilize a financial instrument known as letter-of-credit (LOC). A LOC is an unconditional promise to make payments up to a stated amount for a specified period upon receipt of a proper notice. The commitment is irrevocable. The following are the types of LOCs which are utilized:

Direct Pay Letter-of-Credit

For this letter-of-credit, the investor (through the trustee) looks to the Direct Pay LOC Bank (could be CalSTRS) for all interest and principal payments to investors. The obligor (company or municipality seeking credit) then reimburses the Direct Pay Bank. If the obligor fails to reimburse for the LOC drawing, the fronting bank, with the first loss position in the obligor's creditworthiness, reimburses CalSTRS.

Confirming Letter-of-Credit

For this LOC, the investor (through the trustee) looks to the bank supporting the obligor to make the interest and principal payments to investors. If the bank fails to make these payments, the trustee calls upon CalSTRS to make the payment. CalSTRS would then demand reimbursement from the bank.

Liquidity Facility

This form of LOC is an availability to purchase securities under specific situations. The bonds or commercial paper that this facility supports may be remarketed on a daily, weekly, or monthly basis. There is a need to have their marketability guaranteed. If there is a failed remarketing, CalSTRS may be required to "purchase" these bonds and receive pre-agreed interest payments. In the case of commercial paper, this commitment may be revocable under certain circumstances.

Trustee
A financial institution with fiduciary responsibilities to bondholders (investors) to make principal and interest payments as well as administer all other aspects of the bond indenture.

Bond Indenture
An agreement between an issuer of bonds and the bondholder setting forth the terms and conditions of the bonds. The bond indenture also provides for the appointment of a trustee to act on behalf of bondholders.

III. HISTORICAL OVERVIEW

In 1992, The California State Teachers' Retirement System (CalSTRS) commenced a study to determine the feasibility and prudence of establishing a Credit Enhancement Program in order to earn incremental fee income for the System. In May 1993, the Investment Committee authorized the funds to secure credit ratings from Standard & Poor's (S&P) and Moody's (the two most widely respected credit rating agencies.) Subsequently, CalSTRS has received a AA+ long term rating and a A1+ short term rating from S&P, a Aa2 long term rating and a P1 short term rating from Moody's, and a AA+ long term and F1+ short term rating from Fitch. Policies and procedures for the Credit Enhancement Program were first completed and approved in February 1994 and most recently updated in January 1998.

During the May 1993 presentation to the Investment Committee, the Credit Enhancement Program targets were identified as:

Five Year Target for Outstanding Balances - $1 Billion
(2% of a $50 billion market value)

Five Year Target for Fee Income - $2 Million per annum
(20 basis point average)

CalSTRS executed its first credit enhancement in June of 1994 when it provided a $25 million liquidity facility in favor of the Port of Long Beach.

Since then, CalSTRS has aided 80 California issuers and supported the creation of over 3,000 California jobs. CalSTRS has provided credit enhancement for industrial development bonds, multi-family housing bonds, pollution control bonds, municipality bonds, healthcare related bonds, and other private activity bonds. Further detail on these transactions is included in Section IV, Current Status.

IV. CURRENT STATUS

The Credit Enhancement Program has evolved over time by "word-of-mouth" without an active marketing effort. Disruptions in the capital markets, primarily the Asian emerging markets have created dislocations in financial institutions worldwide. Many investors are developing a preference for CalSTRS as a credit enhancer because of a perception of stability and reliability.

- As of February 1999, total commitments were $512 million and annual fee income of $1.4 million, or 27 basis points.

- As of February 1999, the pipeline for credit enhancement is approximately $250 million at an expected fee income of 20 basis points, or an additional $500 thousand annually.

- ***The Credit Enhancement Program is expected to be on track for the goal of earning fee income at a rate of $2 million per year set five years ago!***

- Annual business expense runs at approximately $100,000 for rating agency fees and personnel and administrative expenses.

- Total fee income generated by the Credit Enhancement Program since 1994 stands at $3.4 million.

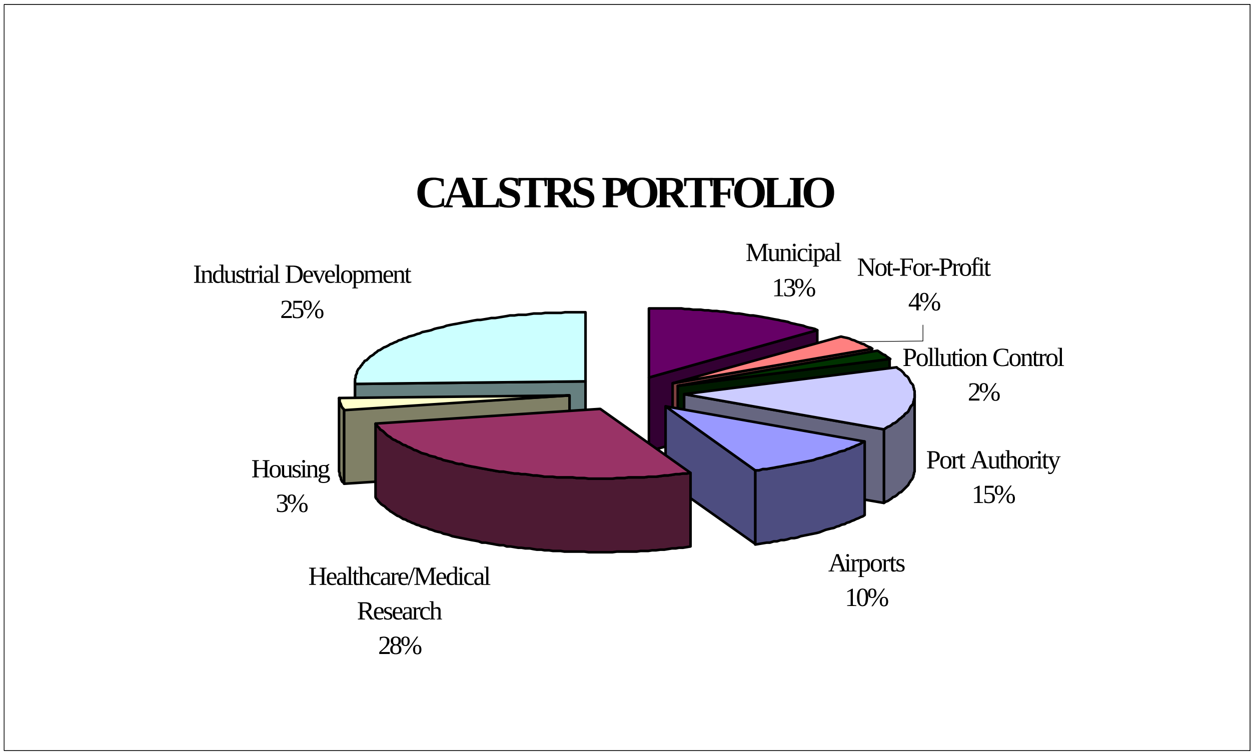
- *Total benefit, which includes fee income as reinvested and compounded at CalSTRS' quarterly return rate, stands at $4.5 million. The extra <u>$1.1 million</u> has been earned from reinvestment and compounding of fee income.*

PORTFOLIO CONSTRUCTION

The following chart and table show the Credit Enhancement Program portfolio. The largest exposures are to the healthcare/medical research (28%) and industrial development (26%) sectors. The healthcare/medical research sector consists of two transactions. One transaction supports a California healthcare system where CalSTRS provides liquidity support to a AAA bond insurer, and the second finances a medical research facility where CalSTRS has 50% of the direct risk which secured by the income generated from an investment trust.

The industrial development sector consists of 60 transactions where CalSTRS provides either a direct pay letter-of-credit or a confirming letter-of-credit support a bank in the capital markets. The banks have the direct risk in each transaction.

Market Sector



CalSTRS provides credit enhancement for other sectors. For the port authority sector, liquidity support is provided for a commercial paper program. For municipalities, credit enhancement is provided for several diverse projects. For the airport sector, liquidity and credit enhancement is provided for a major California airport. CalSTRS either enhances direct credit risk or supports a financial institution in each transaction.

Sector	($Million) Outstanding	% of Portfolio
Airports	$52	10%
Healthcare/Medical Research	144	28%
Housing	15	3%
Industrial Development	130	25%
Municipal	67	13%
Not-For-Profit	19	4%
Pollution Control	10	2%
Port Authority	75	15%
	$512	100%

The table below reflects the CalSTRS credit enhancement portfolio by structure. Only one transaction, which represents 2% of the portfolio, is unsecured with that entity being an investment grade environmental services company.

Portfolio By Structure

Sector	Outstanding	% of Portfolio
Secured by a "AAA" Bond Insurer	$116	23%
Secured by Project Revenue	205	40%
Secured by Income form Trust	28	5%
Secured by Property	26	5%
Secured by Revenues	127	25%
Unsecured (Investment Grade)	10	2%
	$512	100%

Approximately forty percent of the transactions are secured by highly regarded banks with offices located in California. Another twenty–five percent of the transactions are secured by liens on revenue of the underlying entities.

INDUSTRY OVERVIEW

The credit enhancement opportunity set evolves as interest rates and infrastructure needs change with the economic environment. The following chart shows the municipal bond issuance for a six-month period ended December 31, 1998. It gives an idea of the municipal bond credit enhancement market.

UNITED STATES MUNICIPAL BOND ISSUANCE FIRST HALF OF 1998

		Volume $000	No. of Issues
Development	5.7%	$ 1,062,800	71
Education	20.0%	$ 3,757,200	167
Electric Power	3.7%	$ 705,200	7
Environmental	4.4%	$ 828,200	25
Health Care	9.1%	$ 1,720,800	32
Housing	10.0%	$ 1,887,000	92
Public Facilities	3.6%	$ 685,000	29
Transportation	10.2%	$ 1,922,700	21
Utilities	9.2%	$ 1,724,300	44
General Purpose	24.0%	$ 4,516,100	95
	100.0%	$ 18,809,300	

The $18 billion of securities issued represent 600 transactions throughout the United States. The activity is concentrated on general purpose, education, housing, and transportation issues.

Market Opportunities

The fixed rate credit enhancement universe is dominated by five major bond insurers. The bond insurance companies normally enhance fixed rate securities for a 20-30 year commitment. The transaction is structured with a fee paid prior to the issuance of the security which compensates for the credit risk over the term of the bond. If the bond is prepaid, the original fee is earned and a new fee is charged if a new bond is issued.

The variable rate credit enhancement universe is dominated by large U.S. and global banks. Variable rate securities are normally enhanced for a 3-7 year commitment. The transaction is structured with a fee paid on a quarterly basis. The credit enhancement vehicle is normally both liquidity and credit. The credit enhancer must be willing to step in, in the event of a serious market disruption to purchase the bonds for a brief period of time. The repurchase fees charged to the issuer are sufficiently onerous to make this an infrequent event.

The market opportunities for credit enhancement are influenced by several factors:

- Infrastructure growth which is influenced by population and economic growth (see the following demographic data for California).

- Interest rates frequently determine the issuer's appetite for fixed rate or variable rate bonds. When interest rates are higher, issuers will frequently issue variable rate debt with the intention of refinancing the debt when rates drop to lower levels. Conversely, when rates are low, issuers will frequently issue longer term fixed rate bonds to lock in the cost of funding.

Federal laws govern the dollar amount of private activity bonds (multifamily housing, pollution control, etc.) which can be issued. The current limit stands at $50 per capita of state population ($1.6 billion for California). There is federal legislation that, if passed, would raise the eligible amount to $75 per capita or $2.5 billion for California. Private activity financing requests to the California Debt Limit Committee were approximately $4.8 billion in 1998.

While it is unknown exactly how the above variables will combine to shape the demand for credit enhancement over the next several years, it is certain that there will be continued and increased need based on California demographics as shown below.

DEMOGRAPHIC PROJECTIONS
DEPARTMENT OF FINANCE DEMOGRAPHIC PROJECTIONS

	California Population	% Increase from 1998
1998	33,506,406	---
2010	39,957,616	19.3%
2020	45,448,627	35.6%
2030	51,868,655	54.8%
2040	58,731,006	75.3%

As the above demographic projections indicate, California's population is expected to increase by 19.3% over the next eleven years. This increase in population will be acutely felt by California public schools which are expecting an 11% enrollment growth or an added 791,823 students in just eight years.

DEPARTMENT OF FINANCE
DEMOGRAPHIC PROJECTIONS FOR CALIFORNIA SCHOOL ENROLLMENT

	Actual 1998 Enroll	Projected 2007 Enroll	Projected Increase	% Increase
Community Colleges	1,475,711	1,820,194	344,483	23.34%
Public School K-12	5,733,581	6,180,921	447,340	7.80%
Totals	7,209,292	8,001,115	791,823	10.98% wtd.avg.

This tremendous growth provides opportunities within the credit enhancement universe as school districts expand and finance additional classroom space.

V. PERFORMANCE MEASUREMENT

Credit enhancement is an off-balance sheet investment activity that is designed to earn fee income on a selective basis. The fee income is pursued on an *expected zero loss basis*. Risk minimization is a desired objective, which may result in lower fee income. The following chart shows industry performance over the past five years.

ZERO LOSS INDUSTRY STANDARD

Loss and Percentage Loss Incurred by Bond Insurers*

	1997	1996	1995	1994	1993
Principal & Interest Exposure	$1.2 Trillion	$1.1 Trillion	$0.9 Trillion	$0.8 Trillion	$0.6 Trillion
Loss Expense	$52 Million	$19 Million	$34 Million	$7 Million	$13 Million
Percentage Loss	.00426%	.00179%	.00365%	.00090%	.00224%

* Bond insurers included in this S&P report are as follows: FGIC, MBIA, Connie Lee, FSA, Capital RE, Enhance Re, Asset Guaranty, Ambac

VI. Key Issues

A. The primary objective is to earn fee income by providing more California entities access to the capital markets by using the following vehicles:

- California Schools Credit Enhancement (Development Stage)
    - Short-term funding program – Providing capital market funding for school planning, site development, and acquisition financing
    - Permanent financing program – Providing financing for buildings and school rehabilitation
- California Multifamily Housing Projects (Development Stage)
    - Assist mid-level credit quality financial institutions provide construction and mini-term financing for multifamily housing
- California Housing Projects (Ongoing Activity)
    - Assist in the financing of single family and multifamily housing through the liquidity and/or credit enhancement of the California Housing Finance Agency (CHFA)
- California Municipal Finance (Ongoing Activity)
    - Assist bond insurers and mid-level credit quality financial institutions provide credit enhancement to local governmental entities
- California Industrial Development (Ongoing Activity)
    - Assist mid-level credit quality financial institutions provide credit enhancement for companies eligible for industrial development bonds

B. Another objective is to investigate working with a consortium of public U.S. pension funds to provide a national market for credit enhancement to support infrastructure development throughout the United States.

- A large financial institution is interested in working with a limited number of large U.S. public pension funds to provide credit enhancement on a national basis. The financial institution is motivated to provide business development, transaction servicing, risk analysis, and limited first loss protection.

VII. IMPLEMENTATION OBJECTIVES

Credit enhancement is considered a selective program that has the primary objective of earning fee income based on zero underwriting loss standard. As such, the implementation objectives set forth will assist in establishing the market niches to accomplish these ends.

- Establish a California Schools Credit Enhancement Program
- Enhance a California Housing Program
- Investigate the feasibility of a national consortium of pension funds to provide credit enhancement nationwide
- Achieve AAA rating for CalSTRS from both Standard & Poor's and FITCH IBCA rating agencies

VIII. STAFFING ISSUES

The Credit Enhancement Program has been staffed by Fixed Income personnel with the work divided between several people. The Program has approximately seventy transactions to administer is expected to continue to increase.

The Credit Enhancement Program has been only passively marketed over the past five years. The opportunity set for credit enhancement can be greatly expanded by having CalSTRS pursue a more active role in the California public finance community.

Program development for the California Schools Credit Enhancement and the California Housing Programs will require additional resources. Depending on the pace of activity, market opportunities, and desire to develop additional programs, there may be a need to hire additional staff. It is estimated that one or two Investment Officers and one support staff will be required.

CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

CREDIT ENHANCEMENT PROGRAM POLICY MANUAL

INVESTMENT BRANCH
April, 1999

INTRODUCTION

In accordance with the decision by the California State Teachers' Retirement System (CalSTRS) to pursue the development of a Credit Enhancement Program, CalSTRS has established an ongoing program that emphasizes earning fee income through the enhancement of bond transactions.

Credit Enhancement is an off-balance sheet activity that does not affect the CalSTRS asset allocation. The primary objective of the program is to earn fee income. The bond transactions are either governmental or private activity, which have a public purpose (e.g. multi-family housing, industrial development, pollution control). The credit enhancement opportunity set is considered lower risk.

Internal professionals who operate under the direction of the Chief Investment Officer, or designee, perform the management of the credit enhancement activities.

This manual will establish the policies involved in the management of the Credit Enhancement Program. The policies are designed to set boundaries for expected performance, diversification, and investment structure. The procedures are designed to provide guidelines for the implementation of the approved policies. A flow chart is provided to establish context for the policies presented.

WHAT IS CREDIT ENHANCEMENT?

Credit enhancement is an agreement by CalSTRS to provide for the payment of principal and interest in the event that the primary obligor does not meet the terms and conditions of the bond indenture. This substitution (for a fee) allows the public or private entity borrowing access to the capital markets and permits them to pay a lower interest rate to investors. The most utilized form of credit enhancement is a letter-of-credit. Another form of credit enhancement used by the CalSTRS Credit Enhancement Program is called a liquidity enhancement. Liquidity enhancement is used for short term or variable rate securities to give investors confidence in the amount of liquidity associated with a specific security. Most liquidity enhancements contain a lesser degree of credit exposure than letters-of-credit.

The Credit Enhancement Program is an off-balance sheet program since it is a commitment to pay investors in circumstances that are expected to be highly infrequent. The strategic asset allocation plan is not affected.

FORMS OF CREDIT ENHANCEMENT

- Liquidity Support
- Credit Support
- Combination of Liquidity and Credit Support

CREDIT ENHANCEMENT INSTRUMENTS

Credit enhancement transactions normally utilize financial instruments known as letters-of-credit (LOC). A LOC is an unconditional promise to make payments up to a stated amount for a specified period upon receipt of a proper notice. The commitment is irrevocable. The following are the type of LOCs that CalSTRS utilizes:

Direct Pay Letter-of-Credit

For this letter-of-credit, the investor (through the trustee) looks to the Direct Pay LOC Bank (could be CalSTRS) for all interest and principal payments to investors. The obligor (company or municipality seeking credit) then reimburses the Direct Pay Bank. If the obligor fails to reimburse for the LOC drawing, the fronting bank, with the first loss position in the obligor's creditworthiness, reimburses CalSTRS.

Confirming Letter-of-Credit

For this LOC, the investor (through the trustee) looks to the bank supporting the obligor to make the interest and principal payments to investors. If the bank fails to make these payments, the trustee calls upon CalSTRS to make the payment. CalSTRS would then demand reimbursement from the bank.

Liquidity Facility

This form of LOC is an availability to purchase securities under specific situations. The bonds or commercial paper that this facility supports may be remarketed on a daily, weekly, or monthly basis. There is a need to have their marketability guaranteed. If there is a failed remarketing, CalSTRS may be required to "purchase" these bonds and receive pre-agreed interest payments. In the case of commercial paper, this commitment may be revocable under certain circumstances.

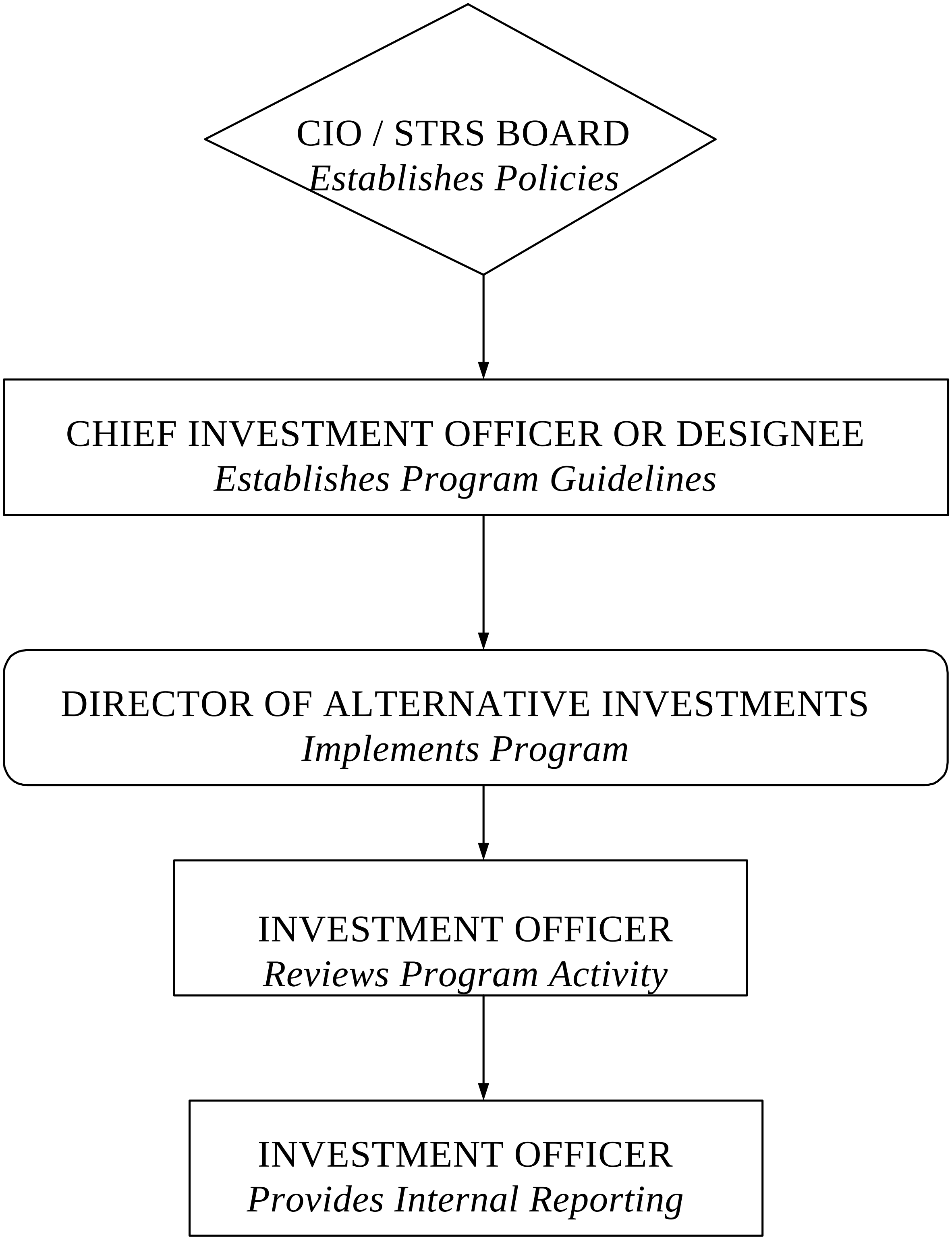
Trustee

A financial institution with fiduciary responsibilities to bondholders (investors) to make principal and interest payments as well as administer all other aspects of the bond indenture.

Bond Indenture

An agreement between an issuer of bonds and the bondholder setting forth the terms and conditions of the bonds. The bond indenture also provides for the appointment of a trustee to act on behalf of bondholders.

CREDIT ENHANCEMENT PROCESS



CREDIT ENHANCEMENT
PROGRAM POLICIES

A credit enhancement is the substitution of a public or private entity's credit standing with that of a financial institution that has a higher credit rating. It is an agreement by a third party to pay the investor any scheduled interest and/or principal payments in the event the primary obligor does not pay. This substitution (for a fee) allows the public or private entity access to the capital markets and permits them to pay a lower interest rate to investors. The most utilized form of credit enhancement is a letter-of-credit. Another form of credit enhancement used in the CalSTRS Credit Enhancement Program is called a liquidity enhancement. Liquidity enhancement is used for short term or variable interest rate securities to give investors confidence in the amount of liquidity associated with a specific security. Most liquidity enhancements contain a lesser degree of credit exposure than letters-of-credit.

The conservative level of credit risk and the potential for substantial fee income combine to make CalSTRS' Credit Enhancement Program a significant contributor to the investment returns.

The following represent the approved policies to be utilized in the management of the Credit Enhancement Program. The policies are designed to set boundaries for the expected performance and structure. Policies approved by the CalSTRS Board cannot be altered without explicit direction from the CalSTRS Board.

1. The Credit Enhancement Program of the California State Teachers' Retirement System is invested in a prudent manner for the sole benefit of CalSTRS' participants and beneficiaries in accordance with California State Law.

2. The primary objective of the Credit Enhancement program is to provide fee income through the enhancement of low risk bond transactions for either governmental entities or private activities that serve a public interest (e.g. multifamily housing, industrial development, pollution control).

3. The structure of the transaction is a primary form of risk management. However, diversification by municipal finance sectors is important to control risk. These transactions are considered low risk and frequently have structural protections that are the primary form of risk control.

4. Credit enhancement is considered a selective investment activity. The maximum amount of outstanding commitments enhanced under the Credit Enhancement Program is limited to two percent (2%) of the market value of the CalSTRS investment portfolio.

5. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the Credit Enhancement Program.

6. Authorization letters which indicate who may sign on behalf of CalSTRS shall be included at the time of the closing of a transaction.

7. Prior to being processed by the Operations Area, all wire transfers and bond purchases shall be signed by two Investment Officers.

8. Graduated limitations of daily authority to wire transfer funds or purchase bonds under specific situations are as follows:

Associate Investment Officer	$ 5 Million
Investment Officer I	$ 10 Million
Investment Officer II	$ 25 Million
Investment Officer III	$ 75 Million
Principal Investment Officer	$200 Million
Director of Alternative Investments	$300 Million
Chief Investment Officer	$500 Million

9. The Credit Enhancement Program will be managed according to an annual business plan whose main business components will encompass an assessment of the credit enhancement market, a review of the portfolio, a review of the strategy, a review of targets, and a resource allocation budget.

10. The Credit Enhancement Program will report on a monthly basis: a) new transactions, b) summary of existing transactions broken down by structure, and c) financial institution risk.

11. The rejection decision for a credit enhancement transaction is delegated to staff with the stipulation that all investment opportunities receive equal opportunity and subject to the appropriate amount of due diligence as defined in the credit enhancement procedures.

12. The approval decision for up to $400 million, per transaction, is delegated to staff as it relates to the Credit Enhancement Program. Each transaction shall have a written positive recommendation by the CalSTRS staff and Chief Investment Officer.

13. The approval decision for the Credit Enhancement Program is delegated to staff considering the following stipulations:

A. All credit enhancement and liquidity enhancement transactions must be for projects that are located in California and the contiguous states including Oregon, Nevada and Arizona. This reduces the time required to complete the due diligence process and increases the probability that potential issues can be identified and resolved at the earliest opportunity.

B All credit enhancement and liquidity enhancement transactions must be completed in conjunction with a third party external to CalSTRS. This “partnership” with another financial institution is designed to help ensure that the private market discipline is present at all transactions.

B. The amount of risk associated with each transaction will be limited to the amount of the total credit risk as defined below subject to limitations in 13C- 4:

1. 50% of the pro-rata direct risk transaction which is shared with a partner financial institution, or

2. 100% of a crdit enhanced transaction in the form a letter-of-credit supporting a project that has another financial institution taking the direct credit risk, or

3. 100% of the liquidity risk in a transaction that is enhanced by a bond insurer.

4. 25% of transactions involving employing agencies such as the California public schools, public colleges and universities, or California Agencies and Departments.

D. All financial partners, as identified in policy 13C, must have an investment grade credit rating by a recognized credit rating agency (such as Moody’s, S&P, Fitch or Thomson BankWatch) or equivalent credit rating documented by the CalSTRS staff.

E. To the extent possible, all fees charged, credit terms, legal conditions and project structures for credit and liquidity transactions should reflect current market conditions at the time of transaction.

F. Diversification by geographic, industry sector and transaction type is desired. The following types of transactions may be financed under the program (the list is not exhaustive):

1. Private activity bonds such as industrial development bonds, pollution control bonds, and multi-family housing,
2. Public and private non-profit entities providing a public good or service,
3. Tax and revenue anticipation notes and commercial paper,
4. City, special district and other governmental financing.

GLOSSARY OF TERMS

Collateralized Letter-of-credit (CLOC): A letter-of-credit issued by a bank, which has pledged collateral for bondholders, if liquidated, to make debt service payment upon a dishonor of the LOC.

Commercial Paper: Short term debt obligations commonly maturing 270 days or less.

Confirming LOC: A letter-of-credit (CalSTRS) that is drawn upon in the event the facing letter-of-credit (the financial institution CalSTRS is enhancing) fails to pay upon a draw.

Direct Pay LOC: A letter-of-credit that is drawn on by the trustee on a regular basis (normally monthly) for interest and principal payments made to investors. The Direct Pay financial institution (CalSTRS) is immediately reimbursed by the obligor.

Financial Guarantee Bond Insurance: Insurance policy written by a monoline insurer, usually a bond insurer.

Indenture of Trust: An agreement between an issuer of bonds and the bondholder setting forth the terms of the bonds. The indenture also provides for the appointment of a trustee to act on behalf of bondholders.

Letter-of-credit (LOC): An instrument issued by a bank unconditionally promising to make payments up to a stated amount for a specified period of upon receipt of proper notice.

Liquidity Facility: An instrument, usually in the form of a LOC or a standby bond purchase agreement, which is available to pay the purchase price upon a bondholder exercising the put option.

Monoline Insurer: An insurer that writes only financial guaranty insurance.

Multiline Insurer: An insurer that provides several types of insurance, including financial guaranty insurance, life/health and property/casualty insurance.

Obligor: One who has an obligation, such as an issuer of bonds, a borrower of money from a bank or another source, or a credit customer of a supplier or retailer.

Reimbursement Agreement: An agreement between the credit provider and underlying obligor setting forth the terms and conditions for repayment to the bank for amounts drawn under the credit facility.

Standby LOC: A letter-of-credit that is drawn upon only if there are insufficient funds from other sources.

Standby Purchase Agreement: A form of liquidity agreement.

Trustee: A financial institution with fiduciary responsibilities as set forth in appropriate bond documents.

Attachment 4
Investment Committee – Item 13
April 7, 1999

PROPOSED
RESOLUTION
OF THE
CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

Subject: Credit Enhancement Policy

Resolution No._____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the Credit Enhancement Policies and has heard oral presentations from Staff; and

WHEREAS, The Staff has recommended the adoption of the Credit Enhancement Policies; Therefore be it

Resolved, that the Investment Committee of the California State Teachers' Retirement Board adopts the Credit Enhancement Program Policies.

Adopted by:
Investment Committee
On April 7, 1999

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James D. Mosman
Chief Executive Officer